

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: December 12, 2007

to: Associate Area Counsel (St. Paul)  
(Small Business/Self-Employed)

from: Branch Chief, Branch 4  
(Income Tax & Accounting)

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subject: Taxability of State Income Tax Credit

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

State X =

State Statute A =

State Statute B =

State Statute C =

State Statute D =

State Constitution Provision =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

\$x =

\$y =

### ISSUES

1. What is the proper federal income tax treatment of the credits available under State Statute A and State Statute B?
2. Is State X required to report refunds issued following application of the credits under § 6041 or § 6050E of the Internal Revenue Code?

### FACTS

State X real property taxes are imposed on a calendar year period and become due Date 1 of the following year. Taxpayers receive a discount if they pay their real property taxes by Date 3. The taxes become delinquent and a penalty is imposed if they are not paid by certain specified dates.

State X mobile home taxes are imposed on a calendar year period and become due Date 2 of the same year. Taxpayers receive a discount if they pay their mobile home taxes by Date 3. The taxes become delinquent and a penalty is imposed if they are not paid by certain specified dates. The taxes are based on the values of the mobile homes.

State Statute A provides for a homestead income tax credit for individuals during taxable years Year 1 and Year 2. The amount of the credit is equal to ten percent of the real property taxes or mobile home taxes that were levied against an individual's homestead, became due during the income tax taxable year, and were paid anytime before filing the income tax return claiming the credit (including a timely filed amended return). The term "real property taxes" does not include any special assessments. An amount placed in escrow by a taxpayer is not considered "paid" until such amount is actually paid to the taxing authority. The credit may not exceed \$x for married persons filing a joint return or \$y for a single individual or a married individual who files a separate return.

If the State Statute A credit exceeds an individual's state income tax liability, the taxpayer can carry forward the unused credit for up to five years. Alternatively, the taxpayer can request that the state tax commissioner issue a certificate for the unused portion of the credit. The certificate can be used against any of the taxpayer's real property tax or mobile home tax liabilities -- not just those imposed on the individual's

homestead -- that become due during the income tax taxable year following the year for which the taxpayer claimed the homestead income tax credit. The counties in State X will treat the receipt of a certificate as a payment when it is transferred to them. The counties will have the authority to implement a system that applies the certificate to the following year's liability or (at the county's option) also permits a cash refund if a taxpayer has already paid the real property tax or mobile home tax liability that becomes due during the income tax taxable year following the year for which the taxpayer claimed the homestead income tax credit. This election—to carry forward an excess homestead credit five years to apply against income tax, or instead receive a certificate to apply against next year's property tax—is irrevocable.

Federal taxable income is used as a starting point in calculating State X income tax for individuals, and there is no add back if a taxpayer claims the State Statute A credit and takes an itemized deduction on the federal return for real property taxes or mobile home taxes paid or accrued. See State Statute C. Consequently, in those circumstances, the State Statute A credit is in addition to a deduction for state income tax purposes.

State Statute B provides for a commercial property income tax credit for individuals and corporations during taxable years Year 1 and Year 2. Passthrough entities pass through the credit to partners, shareholders, or members in proportion to their respective interests in the entity. The amount of the credit is equal to ten percent of the real property taxes or mobile home taxes that were levied against a taxpayer's commercial property, became due during the income tax taxable year, and were paid anytime before filing the income tax return claiming the credit (including a timely filed amended return). The term "real property taxes" does not include any special assessments. The credit may not exceed \$x for any taxpayer. The credit may not exceed \$x for married persons filing a joint return or \$y for a single individual or a married individual who files a separate return.

If the State Statute B credit exceeds a taxpayer's income tax liability, the taxpayer can carry forward the unused credit for up to five years. Unlike the State Statute A credit, there is no option to receive a certificate for the unused portion of the State Statute B credit.

Federal taxable income is used as a starting point in calculating State X income tax for corporations as well as individuals, and there is no add back if a taxpayer claims the State Statute B credit and takes a deduction on the federal return for real property taxes or mobile home taxes paid or accrued. See State Statutes D and C. Consequently, in those circumstances, the State Statute B credit is in addition to a deduction for state income tax purposes.

LAW AND ANALYSIS**Issue 1: What is the proper federal income tax treatment of the credits available under State Statute A and State Statute B?**

Section 61(a) of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of the Code.

Section 164(a) provides for the deduction of the following taxes paid or accrued within the taxable year: (1) state and local real property taxes, (2) state and local personal property taxes, and (3) state and local income taxes. A payment of estimated income tax pursuant to state law constitutes the payment of a tax within the meaning of § 164(a)(3) when the amount is based on a reasonable, good faith estimate of the taxpayer's actual tax liability. See Rev. Rul. 71-190, 1971-1 C.B. 70; Rev. Rul. 82-208, 1982-2 C.B. 58.

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified at § 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. *Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc.*, 460 U.S. 370, 377 (1983). Its purpose is to approximate the results produced by a tax system based on transactional rather than annual accounting. *Id.* at 381. The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. *Id.* at 381-383. One must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions. *Id.* at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See *American Mutual Life Insurance Co. v. United States*, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

As a general matter, a taxpayer who receives a refund of state taxes previously deducted on a prior year's federal income tax return must include the refund in gross income to the extent of any prior federal income tax benefit, in accordance with § 111. A taxpayer who receives a refund of state taxes that were not previously deducted on a prior year's federal income tax return is not required to include the refund in gross income. See Rev. Rul. 93-75, 1993-2 C.B. 63.

### *State Statute A Credit*

The State Statute A credit can affect a taxpayer's liability for state income taxes and/or a taxpayer's liability for real property taxes or mobile home taxes. Specifically, the credit could affect a taxpayer's state income tax liability for the year the credit is claimed or for a carryforward year. Additionally, in all counties, the credit could reduce a taxpayer's liability for real property taxes or mobile home taxes that become due during the income tax taxable year following the year for which the taxpayer claimed the credit. Depending on how the county has implemented the legislation, a taxpayer could also possibly receive a cash refund if the taxpayer has already paid the real property tax or mobile home tax liability that becomes due during the income tax taxable year following the year for which the taxpayer claimed the credit.

If a taxpayer uses the full amount of the State Statute A credit against the state income tax liability for the year the credit is claimed, the credit should be treated as a reduction in the taxpayer's state income tax liability. This affects the amount deductible under § 164(a)(3). For a taxpayer using the cash receipts and disbursements method of accounting, the credit should be taken into account in determining whether the taxpayer made a reasonable, good faith estimate of the taxpayer's actual tax liability for purposes of making estimated state tax payments. For a taxpayer using an accrual method of accounting, the credit should be taken into account in calculating the amount of state tax liability that accrues. Any refund attributable to this credit and any other credits or payments should be analyzed under the tax benefit rule. See *generally* Rev. Rul. 93-75. Of particular relevance, we note that a taxpayer who receives a refund from claiming the credit on a timely filed amended return may have made state tax payments with respect to that tax year during multiple tax years (e.g., during the year in which the credit is claimed and in the following year when the original state income tax return was filed). A refund or other recovery that is for amounts paid in two or more different tax years must be allocated on a pro rata basis. See Rev. Rul. 70-86, 1970-1 C.B. 23; see also page 20 of Publication 525, *Taxable and Nontaxable Income*.

If the State Statute A credit exceeds an individual's state income tax liability, the taxpayer can carry forward the unused credit for up to five years or request that the state tax commissioner issue a certificate for the unused portion of the credit. The State Statute A certificates will be issued by the state, but used by taxpayers to reduce the liability to be paid to the county treasurer. A taxpayer will deliver the certificate to the county treasurer, and the county treasurer will forward it to the state tax commissioner, who then will issue payment to the county. State X real property taxes and mobile

home taxes are used to fund local governments, not the state government. Local governments are political subdivisions of State X, and have only the authority delegated to them by State X in its Constitution and statutes. See State Constitution Provision. Under these circumstances, we conclude that a taxpayer's use of a certificate should not be treated as if a third party paid a debt of the taxpayer. Furthermore, we also conclude that the use of a certificate in timely satisfying a real property tax or mobile home tax liability should be treated as though the government reduced such liability.

The following general tax treatment applies when the State Statute A credit exceeds an individual's state income tax liability: (1) the State Statute A credit carryforward should be treated as a reduction in the taxpayer's state income tax liability in the carryforward years and (2) the use of a certificate to timely satisfy a real property tax or mobile home tax liability should be treated as a reduction in the taxpayer's real property tax or mobile home tax liability. Each of these reductions affects the amount deductible under § 164(a). Additionally, in a county that permits a refund if a taxpayer has already paid the real property tax or mobile home tax liability that becomes due during the income tax taxable year following the year for which the taxpayer claimed the State Statute A credit, such a refund would be subject to the general rules concerning the tax benefit rule, as discussed above, for taxpayers using the cash receipts and disbursements method of accounting who receive the refund in a year after the real property tax or mobile home tax liability was paid. If the real property tax or mobile home tax refund occurs during the same tax year those taxes were paid, the refund reduces the amount otherwise deductible under § 164(a) by a taxpayer using the cash receipts and disbursements method of accounting. See Rev. Rul. 73-579, 1973-2 C.B. 46.

Our general conclusions in the preceding paragraph are based on the limited facts available concerning the certificate program. We understand that the specific details of each county's program are not yet available because the implementation process is currently ongoing. Depending on how a county program operates, there could be additional issues that should be addressed. Consequently, after this information becomes available, you may want to consider requesting further advice.

#### *State Statute B Credit*

The State Statute B credit can affect only a taxpayer's state income tax liability for the year the credit is claimed or for a carryforward year. In accordance with the preceding discussion on the State Statute A credit, the State Statute B credit should be treated as a reduction in a taxpayer's state income tax liability. This affects the amount deductible under § 164(a)(3). For a taxpayer using the cash receipts and disbursements method of accounting, the credit should be taken into account in determining whether the taxpayer made a reasonable, good faith estimate of the taxpayer's actual tax liability for purposes of making estimated state tax payments. For a taxpayer using an accrual method of accounting, the credit should be taken into account in calculating the amount of state tax liability that accrues. Any refund attributable to other credits or payments should be analyzed under the tax benefit rule. See *generally* Rev. Rul. 93-75, 1993-2

C.B. 63. Of particular relevance, we note that a taxpayer who receives a refund from claiming the credit on a timely filed amended return may have made state tax payments with respect to that tax year during multiple tax years (e.g., during the year in which the credit is claimed and in the following year when the original state income tax return was filed). A refund or other recovery that is for amounts paid in two or more different tax years must be allocated on a pro rata basis. See Rev. Rul. 70-86; see also page 20 of Publication 525.

2. Is State X required to report refunds issued following application of the credits under §§ 6041 or 6053E of the Internal Revenue Code?

Information reporting for refunds of state and local taxes may be required under § 6041 or 6050E.

Section 6050E requires information reporting for state and local income tax refunds. Payments of refunds to individuals aggregating \$10 or more must be reported. Form 1099-G is used to report amounts under § 6050E.

In the case of State Statute A, if a taxpayer uses the credit against his state income tax liability for the year the credit is claimed, and receives a refund of state income tax for that year, the amount of the refund must be reported by the state refund officer on Form 1099-G. The refund is reportable irrespective of whether it constitutes income to the taxpayer under the tax benefit analysis outlined above, or whether any such income needs to be allocated between two tax years as described above with respect to the amended return situation.

Under § 6050E(b), a statement must be furnished to the individual who receives the income tax refund. Therefore, a copy of the Form 1099-G must be sent to the taxpayer. However, the regulations state that the refund officer need not furnish this statement to the taxpayer if the refund officer verifies that the taxpayer did not claim itemized deductions for federal income tax purposes. See section 1.6050E-1(k) of the Income Tax Regulations. Verification may be made from the state income tax return if Schedule A, Form 1040, is required to be attached to the state income tax return or information from Schedule A must be transcribed on the state income tax return, the information from Schedule A is required to compute the State X income tax liability, and the omission of Schedule A or information from Schedule A is consistent with the taxpayer's computation on the state income tax return. Thus, if the refund officer can verify that the taxpayer did not claim itemized deductions, a copy of the Form 1099-G need not be furnished to the taxpayer. In the case of Form State X-1, the instructions state that a taxpayer must attach Form 1040 and accompanying schedules, and the state income tax liability appears to be computed from the Federal tax return. Therefore, if the refund officer can verify that no itemized deduction was claimed for the state income taxes, the Form 1099-G for the refund must be filed but need not be furnished to the taxpayer.

If State Statute A credit exceeds the taxpayer's state income tax liability for the year the credit is claimed, it can be carried forward for up to five years. In the alternative, the taxpayer may elect to receive a certificate that it can use to reduce real property or mobile home taxes which are payable to the county. If the credit is carried forward and applied to reduce state income tax liability in subsequent years, any state income tax refunds in those subsequent years will be subject to § 6050E reporting as discussed above. If the taxpayer instead receives a certificate, the use of such certificate to pay, reduce or obtain a refund of real property or mobile home tax would be outside of § 6050E, as it is not a state income tax refund. Instead, any information reporting would be based on § 6041.

Section 6041 requires information reporting for payments of \$600 or more made in the course of a trade or business for rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income. If the refund is reportable under § 6041, the amount reported would be shown on a Form 1099-MISC, shown in box 3 "Other income."

Sections 1.6041-1(b)(1) and (i) of the regulations provide that payments made by a state or a political subdivision are subject to this reporting requirement.

Payments are only reportable under § 6041 to the extent they constitute fixed or determinable income. Under § 1.6041-1(c), income is "fixed" when it is to be paid in amounts definitely predetermined. Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.

If the taxpayer uses a certificate to timely satisfy real property or mobile home tax, such use is treated as a reduction in the tax liability and not income. Therefore, there is no required reporting under § 6041 as there is no fixed or determinable income. If, however, the county permits a refund based on the application of the certificate, there may be income if the taxpayer previously deducted these taxes, based on the tax benefit rule discussed above. In that case, the refund must be reported on Form 1099-MISC to the extent it is income. The county does not have a reporting obligation if it cannot determine the amount that is fixed or determinable income.

The determination of fixed or determinable income in the case of a county property tax or mobile home tax refund is based on whether the taxpayer previously deducted such taxes. As noted above, the state requires the taxpayer to attach Schedule A, Form 1040 to the state income tax return. Therefore, the state has the ability to determine whether the taxpayer previously deducted real property or mobile home taxes and whether the refund constitutes income. The facts do not indicate whether such information is also available to the counties. If a county does not have information on which to determine the amount of the refund payment that constitutes income to the taxpayer, it is not required to issue a Form 1099-MISC.



In the case of State Statute B, a taxpayer can only use the credit to reduce its state income tax liability for the year the credit is claimed or a carryforward year. As discussed with respect to State Statute A, any state income tax refund received by individual taxpayers must be reported on Form 1099-G, pursuant to § 6050E, regardless of whether all or part of such refund does not constitute income. Section 6050E does not apply to state income tax refunds issued to corporations.

Please call (202) 622-4920 if you have any further questions.